

*Federation of Tax Administrators*

Testimony

**IRS Oversight Board**

January 29, 2002

Room B-318 Rayburn House Office Building

William M. Remington, Director

Delaware Division of Revenue

Immediate Past President - Federation of Tax Administrators

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Mr. Chairman and Members of the IRS Oversight Board:

My name is Bill Remington. I am the Director of the Delaware Division of Revenue, and I am before you today representing the Federation of Tax Administrators. FTA is an association of the tax administration agencies in the 50 states, D.C., and New York City. I serve as the immediate past president of the FTA Board of Trustees.

I am pleased to have this opportunity to appear before you to comment on the operations of the Internal Revenue Service. The Board plays an important and unique role in tax administration, and FTA is pleased to be of assistance.

It is my intent to share with you the state experiences in the operation of a tax administration agency and to offer some thoughts on directions that we believe the Board should consider as it establishes its objectives for IRS operations. While there certainly are unique components to the operations of an agency with the size and scope of the Internal Revenue Service, I believe that the federal and state tax agency mission, challenges and experiences are, at their core, the same. We not only have much to share with one another, we can succeed at our jobs *only* if we do work in partnership and seek to learn from one another.

If you take away only one point from my remarks today, I hope it would be on the value of the federal-state partnership. Where we have worked in partnership, whether in training, taxpayer education, audit selection techniques, criminal investigations, sharing data, or any of dozens of other ways, we have saved government resources, improved taxpayer service, minimized the burden on citizens and produced better tax administration. We strongly believe that all decisions on strategy, resource allocation, budgeting or organizational design should continually seek to strengthen the federal-state partnership.

My remaining comments today fall into three categories: technological improvements, data exchange and some specifics involving federal-state cooperation.

### **Technological improvements**

The IRS and states alike are working to modernize their operations and improve their service to taxpayers. Central to that goal is the development of mechanisms and processes in which they can interact with taxpayers electronically and minimize the effort required to deal with non-electronic transactions so that electronic interactions can follow. The cornerstone of that effort at the state and federal level is the e-file program. States have developed two variations on this general effort that warrant consideration by the IRS and this Board.

Before describing those efforts, it is important to note and draw attention to the FedState e-file program. This program stands as a proud example of what can be achieved, to the benefit of states, the federal government and taxpayers alike, when the IRS and the states find a way to work in unison. Notice I did not say in uniformity -- in

FedState e-file, each government remains free to establish its own tax policies, its own filing deadlines, its own forms and otherwise control its own destiny. But, because of the ability of states and the IRS to envision a better future, their willingness to sit down together and work out legal issues, develop procedures and strive toward the necessary level of harmonization, a taxpayer can now file a federal and a state tax return at the same time, electronically, working either with a paid practitioner or from a home computer in nearly every state with an individual income tax.<sup>1</sup> This program has increased the volume of e-filing for everyone (more than 15 million FedState returns were filed in 2001) and made government work better for taxpayers. There are improvements that can be made in the program. Those improvements require programming resources, showing there is still a need to support Fed State e-file in the IRS strategic plan. This is an exemplary program. It deserves the full support of this Board, and, I would like to add, it started as one of those ideas where "they said it couldn't be done."

**2-D Bar Codes.** States have had excellent results with other technological advancements that we believe are of interest to the Board, including the 2-D bar code.<sup>2</sup> This is an innovation that has advanced like wildfire through many of the states that have individual income taxes. The effort began as an experiment in Indiana in 1999; in 2002, about fifteen states will be using the 2-D bar code as part of their tax return processing

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<sup>1</sup> Four states -- California, Maine, Massachusetts and Minnesota -- have chosen to develop their own filing programs (based heavily on the IRS model), rather than participate in the FedState program.

<sup>2</sup> A 2-D barcode is much like an ordinary bar code except that it can hold massive amounts of data. All of the information typically contained on a federal income tax return, including attachments and schedules, would easily fit on a single bar code in a corner of the paper return.

strategy. Also, states (and tax preparers) are continually finding new applications for the technology.<sup>3</sup>

The 2-D bar code technology for tax return processing works as follows. It is used for computer-prepared returns that, for whatever reason, are not electronically filed. When the return is printed to paper, the data on the return is converted into a 2-D bar code that is also printed in a specified location on the return. When the return is processed, the data is captured using a scanning wand or via a highspeed automated scanner rather than manual data entry. The accuracy of data capture from a bar code exceeds 99 percent, and the savings on data entry are conservatively \$1.00 per return. In other words, bar coded returns have nearly all the advantages of an electronic return -- high data accuracy, quick data capture, and minimal manual intervention. For all practical purposes, a refund bar code return can be processed within the same time parameters of an electronic return if steps (e.g., separate post office boxes) are taken to separate the bar code returns at the front end of the process.

States have worked closely with tax preparation firms and software firms to develop standards for the bar codes and their use so that any difficulty (and resulting resistance) for the preparers is minimized. Acceptance among preparation firms and taxpayers is high. In 2001, the seven states using bar-coded returns processed more than 3.3 million such returns. Bar coded returns accounted for more than 20 percent of the paper returns filed in Delaware, Indiana, Illinois, Michigan and Rhode Island.

The value of the bar code has been questioned by some as being a competitor to e-filing and as being less attractive to government than an e-filed return. Those are false

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<sup>3</sup> Some preparers, for example, are interested in adding a bar code to the Form W-2 so that the information can be scanned (rather than data entered) into their system when the taxpayer is in the preparer's office.

arguments, we believe, because the two filing mechanisms do not compete with each other. Rather, paper filing remains the preferred filing mechanism for a particular market segment. Providing better, faster and cheaper service to this market segment simply makes good sense – while we continue to convince them to adopt e-filing instead. It works that way in practice as well as in theory. There is no evidence that states with a 2D bar code program have experienced any loss of e-file volume.

The 2D bar code is revolutionary. With a bare minimum investment, and I'm talking no more than a few thousand dollars, a state can literally tap a paper return with a magic wand and turn it into an electronic return.<sup>4</sup> The state experience with 2D bar codes has been unanimously positive. I truly suspect there is no single innovation the IRS can introduce to improve its return processing operations that will show greater results, and in a faster timeframe, and at less cost, than that of 2-D bar code technology and exploring its many applications beyond the individual income tax return.

**Direct Internet Filing.** Another revolution in state tax return filing is offering taxpayers the ability to complete a state tax return from a Web site and to file that return directly with the state (at no charge) through a secure Internet connection. In 2002, twenty states offer this option to at least some individual income taxpayers. A somewhat smaller number of states also offer direct Internet filing of business or other tax returns. Most states offering direct Internet filing have also developed options for making electronic payments.

States have a variety of approaches to offer as models, everything from California's portal approach in which taxpayers use commercial software firms to file

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<sup>4</sup> Some states (New Jersey and Virginia) have begun to use traditional high speed optical scanning machines to read the bar codes, thus adding to the scalability of the technology to the IRS level.

directly with the state to those in which only a subset of taxpayers may file via the Internet. Some states offer an Internet return that looks just like the paper tax return, where the taxpayer fills in the blanks, the computer does math computations and pre-populates certain fields, and the return is then sent directly from the Web site. Other states use interview questions and replicas of W-2s and 1099s to create a completed return. Other states print a 2-D bar code on an Internet return if the taxpayer wishes to use the software, but file on paper.

States are finding a growing acceptance among taxpayers for direct Internet filing, especially as the general population becomes more accustomed to doing business over the Internet and builds trust in the accuracy and security of the system. In 2001, about 15 states offered direct Internet filing and received more than 500,000 returns or about 2.5 times the number received in the previous year. State tax agencies see Internet filing as an integral part of their processing operations. It's with us to stay, as surely as the Internet itself.

States are not unaware of the controversy that has emerged regarding what some perceive as unfair competition between government-offered direct Internet filing and the use of commercial software and commercial service agencies for tax return preparation and filing. States view direct Internet filing as using the tools available to them to offer better service to the taxpayers. The information and services offered electronically are mathematical computations, electronic access to the printed instructions, and electronic transport through the public Internet. It has not been the states' experience that taxpayers have had trouble in distinguishing between the types of filing assistance government has always and will always offer and the tax and financial planning assistance that is offered

by paid practitioners and is incorporated into private sector tax preparation software. In addition, a number of states use private sector firms in the operation of their direct Internet file programs for development and/or hosting purposes.<sup>5</sup>

We also draw the attention of the Board to a variety of individual state programs that improve general operations through the use of electronic technology, such as Colorado's electronic taxpayer service program, an integrated and heavily automated system of answering taxpayer questions and providing them with needed information.

### **Data exchange**

The cornerstone of cooperative federal-state efforts in tax administration has and will continue to be the data exchange program in which the IRS (under an exchange of information agreement) provides a wide range of tax return information to state tax administration to assist in state compliance programs. For reasons of reducing taxpayer burden as well as cost-effectiveness, the data received from the IRS is the primary individual income tax compliance tool available in the large majority of states. Federal return information is also used to assist in administering other taxes (e.g., corporation income taxes). In addition, states are providing an increasing amount of information to the IRS to assist in its compliance and its research activities.

**FedState Data Exchanges.** The data exchange program must be the highest priority in maintaining an effective FedState tax administration relationship.

Traditionally, the IRS has accorded the program a high priority. We would encourage the Board to understand and reinforce the importance of the data exchange program. In

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<sup>5</sup> This is consistent with the letter and the interpretation of OMB Circular A-76 recently sent by Sen. Baucus and Sen. Bingaman to the Treasury Department regarding the issue of direct Internet filing.



addition, we would make the following specific suggestions with respect to data exchange programs.

- The data exchange program relies on the physical shipping of magnetic tapes and a huge volume of paper exchanges. IRS has begun to examine using electronic technology for exchanging the data for at least parts of the program. Moving to the electronic exchange of data (transcripts and otherwise) would improve the effectiveness of the program and reduce the resources required of both the IRS and the states. We would encourage IRS and the Board to devote adequate resources to move the data exchange to one which relies on the electronic movement of data, rather than the exchange of data on tape and via paper.
- Several years ago, there was a test in which the Social Security Administration (SSA) captured the state wage and tax information from paper W-2's and shared that data (with no or minimal editing and correction) with states through the IRS. States found the data was quite valuable for compliance purposes, particularly if higher quality data and all W-2's could be included in the exchange. The question of whether and what circumstances the W-2 data can be provided to states has been under consideration at IRS and SSA. We would encourage the Board to work with IRS and SSA to determine the most effective means of providing W-2 information to states.
- IRS has developed a variety of sophisticated methods for identifying potentially fraudulent electronic returns at the time they are being processed. States have similar programs, often supported by more field investigation

resources – both in quantity and in proximity to the suspects -- than can be applied by the federal government. Sharing of information on potentially fraudulent returns at the time they are being processed would be of great value to states, and, we presume, to the federal government. We would therefore encourage the Board to support efforts to establish such an exchange of information.

**1099 Reporting.** In a related vein, we would encourage the Board to assess whether recent steps taken by Congress to extend the due date for certain electronically filed information returns (1099s) is appropriate. Many states believe that the appropriate direction should be to accelerate the date on which various information returns are received, particularly returns required to be filed on magnetic media by large payors. In this fashion, the data might be available at the time of processing and aid in identifying quickly, to the benefit of the taxpayer and the state and federal governments, deficiencies with the return. The current practice seems to be to ignore the potential value of the information on the "front-end" of the process and concentrate instead on "back-end" compliance activities.

We would suggest that offering an extension to large, highly automated payors is moving in the wrong direction. For processing purposes, a tax agency needs all filing-related data as quickly as possible. We would ask the Board to consider the value of moving *up* reporting deadlines wherever possible, and of taking all operational steps necessary to have this data available for exchange early in the filing season. Making information reports available electronically on a real-time basis would not only help states stop refund fraud ... it would help the Service do the same.

Along similar lines, the IRS undertakes certain basic processing actions with its 1099 information returns, and those work sufficiently well for the task of identifying under-reporters. A clean database of information returns, however, could be a treasure trove of information for both federal and state criminal investigators. We would encourage the Board to assure itself that the greatest utility is being made of the 1099 information return database.

### **FedState Cooperation**

I opened my remarks with an overview of the importance of FedState cooperation in tax administration. I would like now to offer a few specifics in this area. There are a large number of examples of successful FedState ventures. They include some efforts involving joint audits (particularly some new and sophisticated programs underway in New York and New York City), joint education and taxpayer service, as well as several joint processing activities and a host of others. In some cases, these programs have waxed and waned depending on resources, the interests of individual state and federal employees, changing management philosophies and so forth. Today, however, the IRS has created a bold new organizational structure that was intended, among other goals, to institutionalize the FedState cooperative relationship and ensure its successful continuation throughout the years.

This new organizational structure shows encouraging signs that it can indeed work the way it was intended. It is now time to take the next, difficult step. We must begin to think strategically about our work together. We need to take a systematic

approach to making decisions about what we should be doing together, and how we should be approaching the world we live in today.

There is probably much that we have not done together in the past that we probably should be doing today. Whether we failed to undertake a joint activity because of technological limitations or an inability to see the benefit is unimportant; the terrain has changed, and we believe it is time to collectively and creatively strategize on how we should be working together from this point forward.

One example of something that at one point seemed impossible or undesirable, and today may seem visionary, but is quite possible: a joint-filed return that a taxpayer sends to the state, which processes the return (probably through a bar-code scan if it was not submitted electronically) and instantly sends the data in an electronic format to the IRS. And we need to think about more taxes than the individual income tax. A joint-filed barcode return might work best for corporate returns, which are data-heavy and consume massive amounts of IRS filing resources.

And we should think seriously about how we can work together in criminal investigations and money-laundering investigations. Our governments' abilities complement one another particularly well in criminal investigations. For example, the IRS has more resources than a state to uncover information and conduct investigations, but states are generally far better suited to undertake "on-the-ground" investigations and legwork. These are but two examples of joint activities that should be considered for their value in helping IRS reach its strategic goals. We hope the Board will encourage the Service to build on its new organizational structure to develop a process that assures the

IRS and states will cooperatively and strategically explore their options to develop new ways to work together in the best interests of tax administration and taxpayers alike.

## **Conclusion**

In closing, I hope you find these comments to be thought-provoking and helpful. State tax administration agencies have a vested interest in tax administration at the federal level being as efficient and effective as it can be. We believe that state tax agencies in their “laboratories of democracy” role have been able to develop and test new technologies that can assist the IRS in improving its return processing, and thus its subsequent interactions with taxpayers. In addition, we believe there are steps that can be taken to improve the way IRS and the states work together at the present time. Finally, we stand ready to work with the Board and the IRS in determining the most effective means of working together in the future.

Thank you for your time and attention. I would be pleased to answer any questions.